No. 1210

IN THE

Supreme Court of the United States

(OCTOBER TERM, 1945)

P. G. LAKE, INC.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition For Writ of Certiorari to the United States Circuit Court of Appeals For the Fifth Circuit

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Petition For Writ of Certiorari to the United States Circuit Court of Appeals For the Fifth Circuit

P. G. Lake, Inc., prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fifth Circuit entered in the above styled and numbered cause on April 17, 1945, affirming a decision of The Tax Court of the United States.

OPINIONS BELOW

The opinion of the Circuit Court of Appeals (R. 63) is reported at 148 F. 2d 898. The opinion of the Tax Court (R. 14-21) is reported at 4 T. C. 1.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered April 17, 1945 (R. 69). The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by 43 Stat. 938 (U. S. C. Title 28, Section 347).

QUESTIONS PRESENTED

Does timely constructive receipt of interest by a creditor who was the petitioner's controlling stockholder satisfy the requirement of section 24(c) of the Internal Revenue Code, providing that a debtor making Federal Income Tax Returns on the accrual basis cannot deduct the interest accrued in favor of such a creditor unless "paid within the taxable year or within two and one-half months thereafter"?

Do the provisions of said section apply at all if the interest is actually paid in the year due?

Alternatively, does this statute permit petitioner to deduct the amount actually advanced its creditor on open account before the end of the two and one-half months' period following the year of accrual?

STATUTES INVOLVED

The statutes involved will be found in the Appendix, infra. pages 17-19.

STATEMENT OF THE MATTER INVOLVED

In its income tax return for the calendar year 1939, petitioner claimed a deduction for all of the interest which accrued during that year upon its indebtedness to its principal stockholder (R. 16). The Commissioner, relying upon Section 24(c) of the Internal Revenue Code, disallowed this deduction (R. 17). This disallowance was upheld on petitioner's appeal to the Tax Court (R. 14-21), and the Tax Court's decision was affirmed by the Court below (R. 69).

Federal Revenue Acts have always allowed taxpayers, making income tax returns upon an accrual basis,

a deduction for interest upon ordinary debts as such interest accrued by the passage of time, without regard to when the interest was paid. (Sec. 23(b) I. R. C. Appendix, infra p. 17). But the creditor, if he reported upon the cash basis, was not required to report such interest until it was actually or constructively received by him. This afforded an opportunity, where the relationship between debtor and creditor was close, to distort and minimize improperly taxable income and tax liability by deliberately delaying or withholding interest payments in such manner as to prevent its correlative taxation to the creditor. The Congress met this situation, in 1937, by enacting what is now Section 24(c) of the Internal Revenue Code (Appendix, infra, p. 18). The pertinent Committee Reports are also in the appendix, pp. 19-22, infra.

This section, as applicable here, provides that if a creditor owns 50 per cent, or more, of a corporate debtor's stock, no deduction for interest accrued in favor of such creditor shall be allowed, if (1) the interest was not "paid within the taxable year or within two and one-half months after the close thereof;" and (2) the accounting method of the creditor did not require him to include the interest, unless paid, in his gross income for the period "in which or with which the taxable year of the taxpayer ends." The section, in terms, applies to all expenses deductible under section 23(a) and all interest deductible under section 23(b) of the Code. (See Appendix, p. 17 infra).

In this case the interest accrued during 1939, and was payable January 1, 1940 (R. 16). Petitioner, admitting that its creditor was also its controlling stock-

holder, claimed that the interest which accrued in 1939 was an allowable deduction for that year because constructively received by and constructively paid to the creditor on January 1, 1940, when it was due; and that this constituted payment within "two and one-half months after the close" of its taxable year, as the statute required (R. 6). The Court below held squarely that nothing short of actual payment would satisfy the Statute (R. 66).

The basic facts, as found by the Tax Court, are:

Petitioner, a corporation making its tax returns upon the accrual basis and for calendar year periods (R. 15), was indebted to its president and majority stockholder, P. G. Lake (R. 15). He reported his income for calendar year periods, but upon the cash basis (R. 15). This indebtedness was evidenced by a series of notes, executed in 1936, which matured annually, and which provided for the payment of interest on all outstanding notes on January 1 of each year (R. 15-16). The interest here involved accrued from January 1, 1939, to the close of that year, but was due and payable on January 1, 1940 (R. 16). This interest was accrued and recorded on petitioner's books monthly during 1939 by credits to an "Accrued Interest Payable" account, in which only interest due on this indebtedness was entered (R. 16). Petitioner gave Lake a check for this interest and the principal of one note on May 17, 1940 (R. 16). Lake and wife duly reported this interest as a part of their gross incomes on the community property basis received in 1940 (R. 16).

Petitioner based its claim that all of this interest was constructively received on January 1, 1940, by Lake, its creditor, on these undisputed facts:

1. Lake, as petitioner's president, was fully authorized to draw checks on its bank account for all proper corporate purposes. No counter-signature was required (R. 17).

2. Petitioner's obligation to pay the interest when due was absolute, unconditional, and recognized by its accounting records and otherwise (R. 16-17-46).

3. From January 1, 1940, to May 17, 1940, petitioner with (other than for current expenses) no debts save those owing to Lake, had free and unencumbered bank balances at no time less than $306,-548.05, while the interest and matured note due January 1, 1940, amounted to $156,000.00, so that Lake could have on January 1, 1940, or at any time thereafter, collected the interest merely by writing a check therefor (R. 16-17).

Petitioner also contended, in the Tax Court and in the Court below, that the phrase in Section 24(c)(1) "within the taxable year or within two and one-half months after the close thereof" had reference to the year in which the interest was due, rather than the year in which the interest accrued, so that actual payment on May 17, 1940, of the interest due January 1, 1940, constituted a full compliance with the statutory requirement. Neither the opinion of the Tax Court, nor that of the Court below, dealt specifically with this question.

Nor did the Court below deal with petitioner's alternate contention, likewise duly presented to both Courts (R. 6-16-20-29), that the amount due on open account to petitioner by its creditor, Lake, on March 15, 1940, should be treated as a payment upon the 1939 interest within two and one-half months from the close of that year. This balance was $32,226.89 (R. 16), and, under the undisputed facts and findings, arose in this way: On January 1, 1940, Lake was indebted to petitioner for earlier drawings in the sum of $672.09. Between that date and March 15, 1940, petitioner made disbursements for the account of Lake which increased this balance to $32,226.89 (R. 16). By May 17, 1940, this balance had increased to $55,-815.20 (R. 17). On that date, petitioner issued its check to Lake and he gave petitioner his check for the amount shown by the open account (R. 17). The Tax Court made no finding to that effect, but the undisputed testimony showed that this method of settling the mutual debts by check rather than by offset was followed so that Lake would have in his bank account all data necessary for his individual tax return (R. 42).

SPECIFICATION OF ERRORS TO BE URGED

The following errors in the decision below are specified by petitioner:

1. The Court below erred in holding that constructive receipt of interest by the creditor (Lake, the majority stockholder) within two and one-half months from the close of the taxable year in which the interest accrued (1939) did not require that the

interest be allowed petitioner as a deduction from gross income for the year of accrual.

2. The Court below erred in failing to hold, as a matter of law under the facts found by the Tax Court, that Lake, the creditor, constructively received the interest owing him by petitioner, and accrued in his favor during 1939, on January 1, 1940, when it was due.

3. The Court below erred in failing to hold that the disbursements made by petitioner for the account of Lake, its creditor, prior to March 15, 1940, were payments of an equivalent amount of the interest accrued in Lake's favor during 1939, and due January 1, 1940, so that so much of this interest was deductible by petitioner in computing its 1939 income.

4. The Court below erred in failing to hold that payment by petitioner of the interest (accrued in favor of its majority stockholder during 1939) at any time during the year 1940 (the year it became due and payable) met the requirements of Section 24(c) of the Internal Revenue Code, and required the allowance of the 1939 accrued interest as a deduction from 1939 gross income.

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRIT

The writ of certiorari sought hereby should be allowed because:

I.

The decision below conflicts with a decision of the United States Circuit Court of Appeals for the Sixth

Circuit on the same matter in *Musselman Hub-Brake Company v. Commissioner of Internal Revenue*, 139 F. 2d 65.

In that case, the Sixth Circuit Court reversed a decision of the Tax Court which had held that royalties and interest accrued in favor of a controlling stockholder, during 1937, 1938 and 1939, were not deductible because of Section 24(c) of the applicable Acts, for the reason that they were not paid in cash within two and one-half months after the close of the respective years of accrual. In so doing, the Sixth Circuit Court held (139 F. 2d at p. 68):

> "* * * * *it would seem that Congress meant that the debts were paid when the deductions constituted income actually or constructively received by the creditor.* In other words, if the debtor credited to the account of the creditor sums under circumstances which would require reporting income constructively received or the creditor received property, either tangible or intangible, having a cash value equal to the deduction claimed by the debtor, the deduction would be allowable under the statute, because the creditor would be required to include these sums in his gross income."
>
> (Emphasis supplied.)

In direct conflict with this, the Court below held that:

> "*Where*, as here, *the definite word 'paid' is used* in the statute *we are not permitted* by the theory of fiction *to give that word an indefinite meaning* as taxpayer would have us do *by en-*

grafting on the statute the word 'constructively' (R. 66). * * * * *"

(Emphasis supplied.)

Likewise, the Sixth Circuit held (139 F. 2d at p. 68):

"To construe the word 'paid' to mean that the payment must be in cash, is to distort the statute;"

but the Court below held:

"The ordinary and usual meaning of 'paid' is to liquidate a liability in cash." (R. 66).

Again, the Sixth Circuit said (139 F. 2d at p. 67):

"We are not here concerned with the rule that deductions are a matter of legislative grace and therefore the taxpayer must bring a claimed deduction clearly within the terms of the statute, because the statutes we are considering all relate to deductions. When Section 23 is applied, the deductions in question are clearly allowable, but for Section 24 (c). So, the rule applies that the two sections should be integrated to carry into effect their combined purpose."

but the Court below said:

"For taxpayer to come within the legislative grace granted by Congress and to claim and secure the deduction, it must bring its case within the terms of the statute as written." (R. 66).

That the conflict in the two opinions is irreconcilable, even though the Court below did not cite or refer

to the opinion of the Sixth Circuit,[1] is emphasized by the fact the opinions of this Court cited and primarily relied upon by the Court below *(Massachusetts Mutual Life Insurance Company v. United States*, 288 U. S. 269; *Helvering v. Price*, 309 U. S. 409; and *Eckert v. Burnet*, 283 U. S. 140) were fully discussed and convincingly distinguished in the opinion of the Sixth Circuit Court in the *Musselman* case. Likewise, each Court cited the legislative history of section 24(c);[2] the Sixth Circuit, to support its conclusions that sections 23(a) and (b) and 24(c) "should be integrated to carry into effect their combined purpose;" the Court below, merely to support the statement that section 24(c) was designed "to prevent tax avoidance and tax evasion" without attempting to show that its holding prevented, or tended to prevent, either.[3]

That the two Circuit Courts have given exactly opposite answers to every question pertinent to the decisions reached is further demonstrated by the following summary of these questions and the respective answers made:

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[1]Petitioner knows of no explanation for this. Below, the petitioner cited and largely relied upon the **Musselman** case; the respondent attempted to distinguish it in his brief, and, at argument, admitted that the statements in that case, which petitioner relied upon, conflicted with his position in the case at bar.

[2]The committee reports are in the Appendix hereto, pp. 19 to 22, infra.

[3]There was no tax avoidance or evasion in this case. Lake reported the interest just as he would have done had it been physically paid in cash on January 1, 1940, when due. (R. 16).

1. Does constructive receipt of interest by the creditor within the time fixed by the statute entitle the debtor to deduct the interest? Yes (Sixth Circuit). No. (Fifth Circuit).

2. Does the word "paid" in Section 24(c)(1), supra, require a cash payment? No (Sixth Circuit). Yes (Fifth Circuit).

3. Does the rule that deductions are a matter of legislative grace and are to be strictly construed apply in construing Section 24(c)? No (Sixth Circuit). Yes (Fifth Circuit).

4. Do the decisions of this Court in *Massachusetts Mutual Life Insurance Company v. United States*, 288 U. S. 269; *Helvering v. Price*, 309 U. S. 409; and *Eckert v. Burnet*, 283 U. S. 140 require that the interest deduction claimed be disallowed? Yes (Fifth Circuit). No (Sixth Circuit).

5. Does the legislative history of section 24(c) require such disallowance? No (Sixth Circuit). Yes Fifth Circuit).

II.

The Court below decided (and, we submit, incorrectly decided) an important question of Federal law which has not been, but should be, settled by this Court.

The general question is the construction and application of section 24(c) of the Internal Revenue Code, and the corresponding sections of earlier Acts. The specific point decided below was that only an actual

cash payment within the statutory period satisfied the requirement of the section that the expense or interest be paid within the tax year, or within two and one-half months thereafter.

This Court has never been called upon to construe or apply this statute.

The importance of the question is evidenced by the fact that, since 1941, the Tax Court has delivered at least twenty-eight opinions directly involving the construction and application of the section. These cases are listed in the Appendix, p. 24 infra. Six of these cases have been decided thus far in 1945. Six of the twenty-eight have reached the Circuit Courts; the case at bar (148 F. 2d 898), the *Musselman* case, supra; *Cheltenham, etc. Company v. Commissioner*, 131 F. 2d 863 (C. C. A. 3, 1942); *Lenox Clothes Shop, Inc. v. Commissioner*, 139 F. 2d 56 (C. C. A 6, 1943); *Celina Mfg. Company v. Commissioner*, 142 F. 2d 449 (C. C. A. 6, 1944); *Mansuss Realty Company, Inc., v. Commissioner*, 143 F. 2d 286 (C. C. A. 2, 1944. Four of these (the *Musselman, Lenox, Celina* and the case at bar) directly involved the construction and application of section 24(c)(1), and only in the case at bar was the Tax Court affirmed.

Petitioner is without information as to the number of cases involving the section pending in the Bureau or filed in, but not yet decided by, the Tax Court; but the number of decided cases indicates that there are many times more so pending.

That these cases will give rise to further conflicts which will require action by this Court, unless the

matter is set at rest by reviewing this case, is indicated by the course of these decisions. Thus, the Tax Court is committed to the proposition that constructive receipt satisfies the requirements of section 24(c)(2), *Michael Flynn Mfg. Company*, 3 T. C. 932 (1944). By its decision in the case at bar, that Court seemed committed to the proposition that constructive receipt does not satisfy section 24(c)(1); but a subsequent opinion *(Nock Fire Brick Company*, entered April 21, 1945, C. C. H. Dec. 14,527 (M) held that salaries constructively, but not actually, received were deductible under section 24(c)(1); and this despite the fact that the statute makes no distinction between salaries and interest.[4] The Tax Court refused to apply the *Musselman* case in deciding the case at bar, but after it had been affirmed by the Court below, it cited and applied the *Musselman* case as establishing that deductions are paid "within section (24(c)(1) if the recipient is chargeable with receiving income though such payments are not made in cash." *Lectrolite Corporation*, entered April 20, 1945, C. C. H. Decision 14,530 (M).

Further in the case at bar the Tax Court and the Court below applied the section with the greatest strictness and without considering whether such a construction was necessary to accomplish the Congressional purpose of preventing tax avoidance; although, in subsequent cases just cited, the Tax Court has applied a more liberal rule. Thus, in the present case,

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[4]It was on this basis that the Tax Court in the **Nock Fire Brick Company** decision attempted to distinguish its decision in the case at bar.

where there was no attempt to avoid, or possibility of avoiding, a tax liability, a construction was adopted which will cause petitioner to lose entirely a deduction for interest actually accrued on a bona fide debt. Being on the accrual basis, petitioner cannot take the deduction in the year the interest was actually paid. *Cf. Miller & Vidor Lumber Company v. Commissioner*, 39 F. 2d 890 (C. C. A. 5, 1930). "Even tax administration does not as a matter of principle preclude considerations of fairness." *Angelus Milling Company v. Commissioner*, ... U. S. ..... (May 21, 1945) 65 S. Ct. 1162-65. This unnecessary and improper harshness will certainly produce controversy and conflicts until the question of the section's proper application and construction is decided by this Court.

The holding by the Court below that it was "not permitted" to construe the word "paid" to mean "constructively paid" brings into question the whole line of cases, and the attendant questions of departmental practice and statutory construction, involving the doctrine of constructive receipt and payment. No tax statute has ever used the phrase "constructive receipt." Yet the Regulations have always required taxpayers on the cash basis to report income when constructively, though not actually, received by them. See, for example, Regulations 103, Sec. 19.42-2, Appendix, p. 22, infra. This Regulation has been upheld by many Courts, including the Court below. *A. D. Saenger, Inc. v. Commissioner*, 84 F. 2d 23 (C. C. A. 5, 1936); *Loose v. United States*, 74 F. 2d 147 (C. C. A.

8, 1934); *Hadley v. Commissioner*, 36 F. 2d 543 (App. D. C. 1929); *Schoenheit et al v. Lucas*, 44 F. 2d 476 (C. C. A. 4, 1930); and *Commissioner v. Scatena*, 85 F. 2d 729 (C. C. A. 9, 1936). See, also, *Corliss v. Bowers*, 281 U. S. 376. As to constructive payment, the Tax Court has held, properly construing the statute to accomplish the Congressional purpose, that dividends are paid by a corporation, within the statute providing a credit for dividends "paid" in computing income subject to the tax on undistributed profits (Sec. 27(b)(1), Internal Revenue Code), when constructively received by the shareholder. The Commissioner has acquiesced in this holding. *The Atlantic Land Company*, 43 B. T. A. 74 (1940); *Valley Lumber Company of Lodi*, 43 B. T. A. 423 (1941); *R. H. Bouligny, Inc.*, 45 B. T. A. 456 (1941), Acq. 1942-1 C. B. 3. The basic purpose of this statutory provision allowing a credit for dividends paid, as well as section 24(c) here involved, was to correlate inclusion in income by the payee with deductibility from income by the payor. This purpose is completely accomplished when the statute restricting deductions for accrued expenses and interest is applied so that the payor will be allowed to deduct all of these items which the payee is required to include in income for the year of accural or within two and one-half months thereafter. No such purpose underlay the statute dealt with by this Court in *Massachusetts Mutual Life Insurance Company v. United States*, 288 U. S. 269, chiefly relied on by the Court below; instead this Court there only refused to permit a taxpayer, reporting on the cash basis, to deduct interest accrued but unpaid, and in so doing

emphasized the importance of correlating income with deductions by pointing out that the interest in question was not reported by the payees, nor required to be reported by them under the doctrine of constructive receipt.[5]

A provision of the type of section 24(c) is necessary for the orderly and equitable administration of the Revenue Laws. Its continuation in the Revenue Code is desirable and is to be expected. It is highly important, therefore, that the principles governing its construction and application be settled by this Court as speedily as possible. The problem is wholly one of statutory construction for this Court's "independent judgment." *Commissioner v. Bedford's Estate,* ..... U. S. ....., 65 S. Ct. 1157-1161.

Wherefore, petitioner respectfully prays that this petition for a writ of certiorari be granted.

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[5]**Helvering v. Price,** 309 U. S. 409, and **Eckert v. Burnet,** 283 U. S. 140, were cited below but these cases only deal with the time when bad debt losses are sustained by a taxpayer on the cash basis of accounting; not with constructive payment and receipt.

APPENDIX

A

Statutes Involved

The controlling Statutes are the following subdivisions of the Internal Revenue Code:

"Sec. 23. Deductions from Gross Income.

"In computing net income there shall be allowed as deductions:

* * * * * * * *

"(b) Interest.—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter."

"Sec. 24. Items Not Deductible.

* * * * * * * *

"(b) Losses from Sales or Exchanges of Property.—

"(1) Losses disallowed.—In computing net income no deduction shall in any case be allowed in respect of losses from sales or exchanges of property, directly or indirectly—

(A) Between members of a family, as defined in paragraph (2)(D);

(B) Except in the case of distributions in liquidation, between an individual and a corporation more than 50 per centum in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

"(c) **Unpaid Expenses and Interest.**—In computing net income no deduction shall be allowed under section 23(a), relating to expenses incurred, or under section 23(b), relating to interest accrued—

(1) If such expenses or interest are not paid within the taxable year or within two and one-half months after the close thereof; and

(2) If, by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not, unless paid, includible in the gross income of such person for the taxable year in which or with which the taxable year of the taxpayer ends; and

(3) If, at the close of the taxable year of the taxpayer or at any time within two and one-half months thereafter, both the taxpayer and the person to whom the payment is to be made are persons between whom losses would be disallowed under section 24(b)."

"Sec. 43. Period For Which Deductions and Credits Taken.—

"The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred,' dependent upon the method of accounting

upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. In the case of the death of a taxpayer whose net income is computed upon the basis of the accrual method of accounting, amounts (except amounts includible in computing a partner's net income under section 182) accrued as deductions and credits only by reason of the death of the taxpayer shall not be allowed in computing net income for the period in which falls the date of the taxpayer's death."

B

Committee Reports

H. Doc. No. 337, 75th Cong., 1st Sess., pp. 15-16:

"5. ARTIFICIAL DEDUCTIONS FOR INTEREST AND BUSINESS EXPENSE.

"The committee had presented to it certain cases wherein individuals were indebted to each other or corporations were indebted to the principal stockholders. In fact it was pointed out that personal holding companies were being utilized for the purpose of establishing artificial deductions. The sole stockholder (or a member of his family) of a personal holding corporation borrowed all or a major part of its annual net income and paid interest thereon. In such cases the debtor kept his books and tax returns on the accrual basis and claimed as deductions the accrued interest. On the other hand, the creditor who was entitled to such payments, if he were on the cash

receipts basis, would not be required to report for income tax purposes, the amount owing to him until actual receipt of the money. Under such circumstances the discharge of the debt may be postponed for an unreasonable length of time with the result that the Government is delayed in getting its tax and in many cases the payments fall in a year of no income with the result that little or no tax is paid. The committee believes that such practices between individuals of a family or between corporations under common control should be dealt with in such a manner as to encourage reasonably prompt discharge of such obligations.

"It is, therefore, recommended that in the case of a transaction between persons, who under section 24(a)(6) are not permitted a deduction for loss from sale or exchange of property, where the debtor makes his return on the accrual basis and the creditor makes his return on the cash basis, deductions—under section 23(a), (expenses) and under section 23(b), (interest)—accrued by the debtor within the taxable year but not paid within 2½ months after the close of the taxable year should be disallowed.

"This proposal should serve to stimulate reasonably prompt payment of such accrued expenses in order that the debtor may secure the allowance of the deduction. No hardship should result from the requirement that the amount be paid within 2½ months after the close of the year of accrual since expenses of this nature usually should be paid within that time in the

ordinary course of business. While this restriction would be applicable only to individuals and corporations in relationships covered by section 24(a)(6), this class represents the worst offenders in the use of this loop-hole."

H. Rep. No. 1546, 75th Cong., 1st Sess., p. 31 (1939-1 Cum. Bull. (Part 2) 704, 724-725):

"SECTION 301 OF THE BILL—UNPAID EXPENSES AND INTEREST.

"Section 301 also adds to section 24 of the 1936 act a subsection (c) which denies deductions for unpaid expenses and interest in certain cases. Under existing law, some individuals have attempted to take advantage of the difference in operation between different accounting methods of reporting income to obtain artificial deductions for interest and business expenses. For example, it was found that an individual on the accrual basis became indebted either to an individual with whom he enjoyed a special relationship, such as a member of his family, or to a corporation which he controlled, and his creditor reported income on the cash basis. Thereafter as interest became due on the indebtedness, the debtor on the accrual basis reported the interest as a deduction for income-tax purposes, but he did not make any actual payment to his creditor. Since the creditor was on a cash basis, he reported no income and thus the sum involved escaped income tax altogether, for usually in these cases if the payment were finally made it was done at a time when the cred-

itor had offsetting losses. The use of this device as a practical matter is restricted to situations where the parties occupy special relationships to each other because an ordinary bona fide creditor would not permit his debtor to engage in such a practice.

"Your committee recommends that section 24 of the Revenue Act of 1936 be amended by adding a new subsection under which it is provided that where the creditor, by reason of his method of accounting, is not required to include in his gross income the amount of the expenses or the interest until it is paid, no deduction shall be allowed to the debtor under section 23(a) (for expenses) or section 23(b) (for interest) for sums not paid by the debtor during his taxable year or within 2½ months after the close of such taxable year. This provision is limited in its application to cases in which both the taxpayer and the person to whom the payment is to be made are, at the close of the year of the taxpayer or at any time within 2½ months thereafter, persons between whom losses would be allowed under section 24(b)."

C

Treasury Regulations 103

"**Sec. 19.42-2. Income not reduced to possession.**—Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart, although not then

actually reduced to possession. To constitute receipt in such a case the income must be credited or set apart to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition. A book entry, if made, should indicate an absolute transfer from one account to another. If a corporation contingently credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt."

"**Sec. 19.42-3. Examples of constructive receipt.**— If interest coupons have matured and are payable, but have not been cashed, such interest, though not collected when due and payable, shall be included in gross income for the year during which the coupons mature, unless it can be shown that there are no funds available for payment of the interest during such year. The interest shall be included in gross income even though the coupons are exchanged for other property instead of eventually being cashed. The amount of defaulted coupons is income for the year in which paid. Dividends on corporate stock are subject to tax when unqualifiedly made subject to the demand of the shareholder. If a dividend is declared payable on December 31 and the corporation intended to and did follow its practice of paying the dividends by checks mailed so that the shareholders would not receive them until January of the following year, such dividends are not considered to have

been unqualifiedly made subject to the demand of the shareholders prior to January, when the checks were actually received. As to the distributive share of the profits of a partner in a partnership, see section 188. Interest credited on savings bank deposits, even though the bank nominally has a rule, seldom or never enforced, that it may require so many days' notice before withdrawals are permitted, is income to the depositor when credited. An amount credited to shareholders of a building and loan association, when such credit passes without restriction to the shareholder, has a taxable status as income for the year of the credit. If the amount of such accumulations does not become available to the shareholder until the maturity of a share, the amount of any share in excess of the aggregate amount paid in by the shareholder is income for the year of the maturity of the share."

D

List of cases involving the construction of Section 24(c) decided by the Tax Court between February 19, 1941, and June 19, 1945:

1. Fincher Motors, Inc., 43 B. T. A. 673 (Feb. 19, 1941).
2. Lenox Clothes Shops, Inc., 45 B. T. A. 1122 (Dec. 30, 1941).
3. Cosmo Cleaners & Dyers, Inc., C. C. H. Dec. 12,452-B (Mar. 9, 1942).
4. The Marria Transfer Company, C. C. H. Dec. 12,459-G (Mar. 13, 1942).
5. Cheltenham & Abington Sewerage Co., C. C. H. Dec. 12,486-C (Mar. 28, 1942).

6. Bellamy Ice Cream Co., Inc., C. C. H. Dec. 12,487-B (Mar. 30, 1942).
7. Moore & McDavid Company, C. C. H. Dec. 12,823-F (Aug. 21, 1942).
8. Cowden Chevrolet Co., C. C. H. Dec. 12,823-G (Aug. 21, 1942).
9. Crown Hill Cemetery Co., C. C. H. Dec. 12,828-H (Sept. 8, 1942).
10. The Celina Manufacturing Co., 47 B. T. A. 967 (Oct. 30, 1942).
11. The Musselman Hub-Brake Co., C. C. H. Dec. 12,884-C (Nov. 10, 1942).
12. Wollner Manufacturing Co., Inc., C. C. H. Dec. 13,088(M) (Mar. 27, 1943).
13. R. Fretwell & Sons, Inc., C. C. H. Dec. 13,107(M) (Apr. 8, 1943).
14. Mansuss Realty Co., Inc., 1 T. C. 932 (Apr. 14, 1943).
15. Birch Ranch and Oil Company, C. C. H. Dec. 13,881(M) (Apr. 20, 1944).
16. Michael Flynn Manufacturing Co., 3 T. C. 932 (June 1, 1944).
17. Thomas B. Martindale, Inc., C. C. H. Dec. 14,036 (M) (July 14, 1944).
18. I. Beck & Sons, Inc., C. C. H. Dec. 14,071(M) (Aug. 1, 1944).
19. Eugene Ashe Electric Company, C. C. H. Dec. 14,097(M) (Aug. 11, 1944).
20. P. G. Lake, Inc., 4 T. C. 1 (Sept. 15, 1944).
21. Ennis Manufacturing Company, C. C. H. Dec. 14,123(M) (Sept. 15, 1944).

22. M. W. Turner, Sr., C. C. H. Dec. 14,257(M) (Nov. 29, 1944).
23. Davis B. Thornton, Transferee, C. C. H. Dec. 14,324(M) (Jan. 11, 1945).
24. Lectrolite Corporation, C. C. H. Dec. 14,530(M) (Apr. 20, 1945).
25. Nock Fire Brick Company, C. C. H. Dec. 14,527 (M) (Apr. 21, 1945).
26. The Bellows Company, C. C. H. Dec. 14,532(M) (Apr. 25, 1945).
27. J. R. Holsey Sales Co., C. C. H. Dec. 14,551(M) (May 8, 1945).
28. Ohio Battery & Ignition Co., 5 T. C. ..... No. 32 (June 19, 1945).

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CITATIONS

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In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 210

P. G. LAKE, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 14–21) are reported in 4 T. C. 1. The opinion of the Circuit Court of Appeals (R. 62–66) is reported in 148 F. 2d 898.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on April 17, 1945 (R. 66). The petition for a writ of certiorari was filed on July 9, 1945. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Was interest payable to the taxpayer's principal stockholder, which was accrued by the taxpayer in 1939, deductible under Section 23 (b) of the Internal Revenue Code as constructively received and constructively paid, or was the deduction prohibited by the provisions of Section 24 (c) because not paid within two and one-half months after the close of the taxable year 1939?

2. Does the phrase "within the taxable year or within two and one-half months after the close thereof", contained in Section 24 (c) (1), refer to the year of accrual or the year in which the interest became due and payable?

3. Alternatively, were advances made to the principal stockholder within two and one-half months after the close of the taxable year 1939, which were carried in a separate account and were not offset against the interest account, deductible as interest paid?

STATUTE INVOLVED

The applicable provisions of the statute involved are set out in the Appendix, *infra*, pp. 15–16.

STATEMENT

The facts as found by the Tax Court (R. 15–17) may be summarized as follows:

The taxpayer, P. G. Lake, Inc., is a corporation chartered under the laws of Delaware and engaged in the business of oil production at Tyler,

Texas. The return for the taxable year 1939 was filed on the calendar year accrual basis. (R. 15.)

P. G. Lake, president and one of the directors of the taxpayer, and actively in charge, owned 60 per cent of its stock. The balance was owned by his children or by trusts created by Lake for the benefit of his children. Lake kept his books and made his returns on the calendar year cash receipts and disbursements basis. (R. 15.)

In 1936 the taxpayer became indebted to Lake in the amount of $1,950,000 on account of a purchase of stock from him. This indebtedness was evidenced by 20 notes. One in the amount of $50,000 became due and was paid in 1936. The remaining notes, each in the principal sum of $100,000, were payable serially on January 1 of each year thereafter for 19 consecutive years, beginning January 1, 1937. Each of the notes bore interest at the rate of three and one-half per cent per annum, payable on January 1 of each year. (R. 15–16.)

The taxpayer accrued the interest monthly, crediting a ledger account designated "accrued interest payable" with the amount of the accrual the first day of each month. The amounts credited to this account represented only interest accrued upon the indebtedness owing Lake, and the taxpayer did not accrue interest in favor of any other creditor. (R. 16.)

On December 31, 1939, the accrued interest payable account showed a credit balance of $55,-

844.45. On May 17, 1940, the taxpayer paid Lake by check the amount of $156,000, representing principal in the amount of $100,000 and interest of $56,000. The interest was composed of $55,-844.45 accrued to December 31, 1939, plus $155.55 accrued on January 1, 1940. No entry prior to May 17, 1940, reflecting payment of this amount of interest was made on the taxpayer's books. Interest in the amount of $165.31 on account of one day, January 1, 1939, had previously been paid on November 2, 1939, and was concededly a proper deduction. (R. 16, 17.)

In its return for the year 1939 the taxpayer deducted interest in the amount of $56,009.76, consisting of $55,844.45 shown as a credit balance in the accrued interest payable account as of the close of the year and $165.31 paid on November 2, 1939. Lake and his wife filed tax returns for the year 1940 on the community property basis, together reporting as income the item of $56,000 interest. (R. 16.)

Since commencing operations, the taxpayer had maintained an open account receivable carried in Lake's name, representing loans to Lake for personal reasons. The account was settled periodically, but at irregular intervals, by Lake's payment of the amount owing. On January 1, 1940, this account showed a balance due from Lake of $670.36. On March 15, 1940, the balance was $32,226.89. By the end of April 1940, the balance amounted to $55,762.09, and on May 17,

1940, Lake issued his check to the taxpayer in the amount of $55,815.20, discharging the then existing balance. The accrued interest payable account and the personal account in the name of Lake were kept separately and the balances were never offset against each other. (R. 16–17.)

As president of the taxpayer, Lake was authorized to draw checks on its bank account and disburse funds for any proper purpose. No countersignatures were required. On January 1, 1940, the taxpayer had on deposit a cash balance of $346,348.16. The lowest cash balance between that date and May 17, 1940, was $306,548.05. Except for the indebtedness due Lake, there were no commitments against this balance. (R. 17.)

The Commissioner disallowed the deduction of interest in the amount of $56,009.76, "in accordance with the provisions of section 24 (c) of the Internal Revenue Code" but later conceded before the Tax Court that the amount of $165.31 representing interest for one day, January 1, 1939, and paid on November 2, 1939, was properly deductible. The amount of interest in controversy is $55,844.45, representing interest accrued from January 2, 1939, to December 31, 1939. (R. 17.)

The Tax Court sustained the determination of the Commissioner to the extent of the disallowance of $55,844.45 of the interest deduction claimed (R. 21). The Circuit Court of Appeals for the Fifth Circuit affirmed (R. 66).

ARGUMENT

1. There is no direct conflict, as alleged by the taxpayer (Pet. 7–11), between the decision in the instant case and that of the Circuit Court of Appeals for the Sixth Circuit in *Musselman Hub-Brake Co.* v. *Commissioner*, 139 F. 2d 65. It is true that the court below held that the word "paid", as used in Section 24 (c) (1), of the Internal Revenue Code (Appendix, *infra,* p. 15), referred only to a liquidation of a liability in cash. In the *Musselman* case, the Sixth Circuit held that "paid" included a satisfaction of the debt by the issuance of notes within the prescribed period, where the notes had a ready realizable market value equal to par value at the time of their receipt and the recipient had reported their value as income for the year in which received. But this case presents no such situation. No notes were given and no payment of interest was made until May 17, 1940, beyond the period prescribed in Section 24 (c) (1). Thus the facts in the instant case fall clearly within the language of the court in the *Musselman* case (139 F. 2d at 69) of a "mere accrual" of interest on the taxpayer's books and not a payment of interest. For reasons indicated by the argument in subdivision 3, *infra,* pp. 9–13, we think the *Musselman* decision was wrong, but we do not find such a direct conflict as to warrant further review by this Court.

2. The taxpayer (Pet. 11–16) urges that an important question of federal law is involved which should be settled by this Court, namely, whether the term "paid," as used in Section 24 (c) (1), includes constructive payment. The taxpayer asserts (Pet. 13) that the Tax Court is committed to the proposition that constructive receipt satisfies the requirements of Section 24 (c) (2), and in some cases dealing with salaries has held that constructive receipt by the creditor equals payment under Section 24 (c) (1). In *Michael Flynn Manufacturing Co.* v. *Commissioner*, 3 T. C. 932, relied upon by the taxpayer, the attention of the Tax Court was directed to Section 24 (c) (2). (Appendix, *infra*, p. 16.) The question was whether an unpaid salary, credited to the account of a principal stockholder and subject to his withdrawal on demand, was includible in the gross income of a creditor for the taxable year of the debtor. The Tax Court, relying on the doctrine of constructive receipt, held that the salary was available to the creditor and had properly been reported as income. In the instant case, the amount sought to be deducted was not due and payable to Lake until after the close of the taxpayer's taxable year, 1939. Being on the cash basis, Lake could not have included any sum on account of interest paid in his income tax return for the year 1939, since it was not paid to him until the year 1940, and there is no theory on

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which it could be held that it was constructively received by Lake in 1939. Nor did Lake report it as income in that year, but in 1940. While the Tax Court has not always been consistent in its various holdings under Section 24 (c) and in some cases has held that an amount includible in gross income of the recipient under Section 24 (c) (2) is to be considered as paid under Section 24 (c) (1), it is unnecessary to resolve any conflict in its decisions in this case, for under no theory of constructive receipt was there such a receipt here. The constructive receipt doctrine is based upon the fact that a person is free by his own action or inaction to reduce money to his control and possession. It must be unqualifiedly subject to his demand. That is not the case here. The unpaid interest until paid was subject to the control of the taxpayer and not Lake, the creditor. There can be no constructive receipt without an unconditional credit on the books of the debtor in favor of the creditor, and the interest in the instant case was not credited to Lake on the taxpayer's books, nor was it ordered to be paid to him in 1939 or within two and one-half months after the close of that taxable year, the period prescribed in Section 24 (c) (1). (R. 16, 19–20).

It should be noted, moreover, that in *Jenkins* v. *Bitgood,* 101 F. 2d 17, 19 (C. C. A. 2d), certiorari denied, 307 U. S. 636, it was specifically held that constructive receipt is not correlative with payment. In that case a note was held taxable as

income to the recipient on the constructive receipt theory without permitting a corresponding deduction for payment by the maker. Constructive payment is a fiction applied only under unusual circumstances. *Mass. Mutual Life Ins. Co.* v. *United States,* 288 U. S. 269, 273–274; *Keith* v. *Commissioner,* 139 F. 2d 596 (C. C. A. 2d). And the theory of constructive payment was rejected in *Sanford Corp.* v. *Commissioner,* 106 F. 2d 882 (C. C. A. 3d), affirming 38 B. T. A. 139, certiorari denied, 309 U. S. 659, and in *Fincher Motors, Inc.* v. *Commissioner,* 43 B. T. A. 673, 676, a case arising under this very statute.

3. Finally, we believe that the court below properly held that an amount is not paid within the meaning of Section 24 (c) (1) unless paid in cash. The taxpayer here is claiming a deduction for interest accrued under Section 23 (b) of the Internal Revenue Code (Appendix, *infra,* p. 15). Under the provisions of Section 24 (c) an accrued deduction for interest is not allowable (1) if not paid within two and one-half months after the close of the taxpayer's taxable year; (2) if the amount is not includible in the creditor's gross income for the taxable year in which or with which the taxable year of the taxpayer ends; and (3) if, at the close of the taxpayer's taxable year or at any time within two and one-half months thereafter, both the taxpayer and the creditor are persons between whom losses would

be disallowed under Section 24 (b) (1) (Appendix, *infra*, p. 15). Admittedly the requirements of subparagraphs (2) and (3) of Section 24 (c) have been met under the facts of the instant case. The only issue raised by the taxpayer is whether the interest was "paid" within two and one-half months after the close of the taxable year in which accrued by the taxpayer as required by Section 24 (c) (1).

Congress has used the word "paid" in the literal sense. Cf. *Mass. Mutual Life Ins. Co.* v. *United States*, 288 U. S. 269, 270, 275. The ordinary and usual meaning of "paid" is to liquidate a liability in cash. *Helvering* v. *Price*, 309 U. S. 409, 413; *Eckert* v. *Burnet*, 283 U. S. 140, 141, 142; *United States* v. *Mitchell*, 271 U. S. 9, 12. A payment must deplete the assets of the debtor. In the instant case, the taxpayer did not liquidate its liability for the payment of interest until May 17, 1940, when Lake issued his check to the taxpayer discharging his indebtedness (R. 17) and the taxpayer paid Lake by check for the interest owed (R. 16). That was the date of payment and being more than two and one-half months after the close of the taxpayer's taxable year 1939, the payment fails to comply with the requirements of Section 24 (c) (1). Thus an allowance of the accrued deduction for interest "paid" is not allowable under Section 23 (b) of the Code. *Mansuss Realty Co.* v. *Commissioner*, 143 F. 2d 286 (C. C. A. 2d).

There is no resulting "harshness", as suggested by the taxpayer (Pet. 14), in literally construing the statute to mean actual payment, since by making payment within two and one-half months after the close of the taxable year the item of interest accrued in 1939 would be an allowable deduction if not prohibited by the other provisions of Section 24 (c). The taxpayer had ample unappropriated cash (R. 17) and it could have avoided the application of Section 24 (c) (1) by making payment prior to March 15, 1940. In any event, the plain obvious and rational meaning of the statute cannot be sacrificed even for the exigency of a hard case. *Deputy* v. *du Pont*, 308 U. S. 488, 498.

The taxpayer urges (Pet. 13) that the word "paid" includes constructive payment or constructive receipt by Lake of the interest due within the prescribed period. It is inconceivable that Congress used the words "paid * * * within two and one half months" after the close of the taxable year in any other sense than a liquidation of the indebtedness by actual payment within the period prescribed. The legislative history [1] shows that Congress was well aware that closely owned

[1] Section 24 (c) of the Internal Revenue Code was first enacted as Title III, Section 301 of the Revenue Act of 1937, c. 815, 50 Stat. 813, amending Section 24 (a) of the Revenue Act of 1936. See Report of the Joint Committee on Tax Evasion and Avoidance, H. Doc. No. 337, 75th Cong., 1st Sess., pp. 15–16, and H. Rep. No. 1546, 75th Cong., 1st Sess., p. 29 (1939–1 Cum. Bull. (Part 2) 704, 724–725).

corporations on the accrual basis were accruing items for expenses, salaries and other indebtedness which were deducted by the corporations but were not paid to or taken up as taxable income by creditors on the cash basis during the year of accrual. The result was that collection of the tax on items which a corporation had deducted was postponed and might never occur. Corporations were reaping the benefit of substantial deductions from income while the alleged recipients were postponing the payment of income taxes on the amount or indeed escaping tax on them altogether by choosing the year of receipt or postponing receipt indefinitely. It was to prohibit such practices, fast becoming common, that Section 24 (c) was enacted, and it was designed to compel actual payment within two and one-half months after the close of the taxable year in order to obtain a deduction for an accrued liability.

In view of the object to be accomplished, it would attribute an undue naïveté to the legislators to say that by use of the word "paid" they meant to leave open the loophole of "constructively paid". Where the definite word "paid" is used in a statute the courts may not engraft the word "constructively" thereon. Moreover, deductions from income are not a matter of right but of legislative grace and the taxpayer here does not bring its case squarely within the terms of the statute as written. *White* v. *United States,* 305 U. S. 281,

292; *Deputy* v. *du Pont,* 308 U. S. 488, 493; *New Colonial Co.* v. *Helvering,* 292 U. S. 435, 440.

The taxpayer's contention (Pet. 5) that the phrase "within the taxable year or within two and one half months after the close thereof", contained in Section 24 (c) (1), refers to the year in which the interest became due and payable (1940), and not the year of accrual of the interest by the taxpayer (1939), is untenable. *Mansuss Realty Co.* v. *Commissioner,* 143 F. 2d 286 (C. C. A. 2d). Section 24 (c) (1) deals with the accrual of a liability and its payment by a taxpayer, and not with the year when the obligation became due and payable. The interest which was accrued by the taxpayer and deducted in 1939 was properly accrued in that year. *Dixie Pine Co.* v. *Commissioner,* 320 U. S. 516, 519; *United States* v. *American Can Co.,* 280 U. S. 412, 419–420; *United States* v. *Anderson,* 269 U. S. 422. Congress therefore required payment of an accrued liability within two and one-half months after the close of the taxable year of the accrual taxpayer. This is the plain wording of the statute and its evident purpose.

4. The taxpayer alternatively contends (Pet. 2, 6) that advances in the sum of $32,226.89, made by the taxpayer to Lake prior to March 15, 1940, should be considered as the payment of interest. The findings of the Tax Court (R. 16–17) support its holding (R. 20–21) that from the treatment of

the personal loan account by the parties it was not considered a payment on account of accrued interest. It was an entirely separate account and so kept. No offset against the interest account payable to Lake was entered as the advances were made or when Lake was paid the accrued interest. The two separate accounts, one for interest due (R. 46–51) and the other for loans or advances (R. 54–58), are set out in the record. The accounts were never commingled or offset. (R. 17, 20–21.)

CONCLUSION

The decisions below are correct and there is no warrant for further review by this Court. The petition should be denied.

Respectfully submitted.

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AUGUST 1945.

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, * * *

* * * * *

(26 U. S. C., Sec. 23.)

SEC. 24. ITEMS NOT DEDUCTIBLE.

* * * * *

(b) *Losses from Sales or Exchanges of Property.*—

(1) *Losses Disallowed.*—In computing net income no deduction shall in any case be allowed in respect of losses from sales or exchanges of property, directly or indirectly—

* * * * *

(B) Except in the case of distributions in liquidation, between an individual and a corporation more than 50 per centum in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

* * * * *

(c) *Unpaid Expenses and Interest.*—In computing net income no deduction shall be allowed under section 23 (a), relating to expenses incurred, or under section 23 (b), relating to interest accrued—

(1) If such expenses or interest are not paid within the taxable year or within two

and one half months after the close thereof; and

(2) If, by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not, unless paid, includible in the gross income of such person for the taxable year in which or with which the taxable year of the taxpayer ends; and

(3) If, at the close of the taxable year of the taxpayer or at any time within two and one half months thereafter, both the taxpayer and the person to whom the payment is to be made are persons between whom losses would be disallowed under section 24 (b).

* * * * *

(26 U. S. C., Sec. 24.)

U. S. GOVERNMENT PRINTING OFFICE: 1943

No. 210

IN THE

Supreme Court of the United States

(October Term, 1945)

P. G. LAKE, Inc.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition For a Writ of Certiorari to the United States Circuit Court of Appeals For The Fifth Circuit

REPLY TO RESPONDENT'S BRIEF IN OPPOSITION

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REPLY TO RESPONDENT'S BRIEF IN OPPOSITION

I.

Respondent seeks to distinguish the decision of the Circuit Court of Appeals for the Sixth Circuit in *Musselman Hub-Brake Company v. Commissioner*, 139 F. (2d) 65, from the decision of the Court below in the instant case on the ground that notes were issued by the debtor in the cited case within the prescribed period (Brief 6). On this basis, respondent avers that the two decisions are not in "direct conflict" (Brief 6).

The fact that notes were issued by the debtor in the *Musselman* case in no way alters the inexorable conclusion that a direct conflict exists in the two decisions, as may be seen from the following considerations:[1]

1. Section 24(c)(1) uses the word "paid." This Court has previously held that the giving of a note by a debtor is not a payment in cash or its equivalent for purposes of the bad debt or loss provisions of the taxing acts. *Eckert v. Burnet*, 283 U. S. 140, and *Helvering v. Price*, 309 U. S. 409. A fortiori, the giving of notes by the Musselman Hub-Brake Company did not and could not constitute a payment in cash, and "the giving of the taxpayer's own note was not the equivalent of cash." *Helvering v. Price*, supra, at page 413.

Respondent, as did the Court below, interprets the word "paid" as used in Section 24(c)(1) to mean liquidate in cash (Brief 10). It was for this reason that respondent expressed his belief that the "Musselman decision was wrong." (Brief 6). This is a plain admission by the respondent that the two decisions are in direct conflict, for it recognizes that the notes executed by the Musselman Company constituted nothing more than a form of constructive payment.

[1]This should be considered in the light of the fact that petitioner here had its own notes outstanding promising to pay interest as well as principal (R. 46). Lake, the payee, had the immediate right to enforce the payment of this interest on Jan. 1, 1940. In the **Musselman** case, the notes extended the time of payment.

The Musselman Hub-Brake Company was in the same identical economic, factual and legal position, so far as payment to its creditor is concerned, as was your petitioner who, it must be remembered, had already executed notes to its creditor for the principal of the debt, which notes according to their terms promised to pay the interest here sought to be deducted. (R. 46). In neither case (except as to the amount covered by Petitioner's Specification No. 3, Pet. 7) was there an actual cash payment to the creditor. In both cases, the debtor, to bring itself within the purview of Section 24(c)(1), had to rely upon the doctrine of constructive payment. This doctrine was accepted by the Sixth Circuit Court of Appeals. It was rejected by the Court below. The decisions are in irreconcilable conflict.

2. The Sixth Circuit Court of Appeals in the most explicit language considered the controlling question to be "the applicability of the rule of constructive payment." (139 F. (2d) at p. 69). That Court likewise held that the debts were so paid when they "constituted income actually or constructively received by the creditor." (139 F. (2d) at p. 68). Constructive receipt of income by a creditor can and does occur whether he obtains notes from his debtor or not. (See Sec. 19.42-3, Regs. 103, Appendix Pet., p. 23-24). The decision by the Sixth Circuit Court of Appeals that constructive payment satisfies the requirements of Section 24(c)(1) cannot, therefore, on grounds of substance and reality, be said not to be in conflict with the decision of the Court below.

3. The Tax Court of the United States has cited and applied the Musselman decision as authority for the proposition that constructive payment satisfies the requirements of Section 24(c)(1). *Nock Fire Brick Company*, entered April 21, 1945, C. C. H. Decision 14,527(M); *Lectrolite Corporation*, entered April 20, 1945, C. C. H. Decision 14,530(M). In neither of the last cited cases were notes given by the debtor to the creditor. Obviously, therefore, the ground upon which respondent seeks to differentiate the *Musselman* case from the instant one is considered by the Tax Court as of no moment or importance.

II.

While admitting that the Tax Court decisions under Section 24(c) are in conflict, (Brief 8) respondent states that "it is unecessary to resolve any conflict in its decisions in this case, for under no theory of constructive receipt was there such a receipt here." (Brief 8). Respondent then states that "The constructive receipt doctrine is based upon the fact that a person is free by his own action or inaction to reduce money to his control and possession." (Brief 8). Employing this test, it is manifest that Lake was in constructive receipt of the interest in question under the following controlling facts:

1. The interest was due and payable January 1, 1940.

2. The obligation to pay was admitted and unconditional.

3. This obligation was then set up on the books of petitioner as a payable then due.

4. The petitioner had ample unappropriated cash with which to pay the interest throughout the two and one-half months period.

5. This interest was due to petitioner's President, P. G. Lake.

6. Lake had unlimited authority to check upon petitioner's account for any proper purpose without counter-signature.

7. All that Lake had to do to collect physically this interest on January 1, 1940, or any time thereafter, was to draw a check therefor.

These undisputed facts make out a conclusive case of constructive receipt. Nothing more than the Regulation is required to support this. "Income * * * set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart." The item of income "must be available to him so that it may be drawn on at any time, and its receipt brought within his own control and disposition." "His own control and disposition" is the key phrase. That Lake did have such control and power of disposition is obvious when all that he had to do to effect a physical collection was to write a check. Could Lake have defeated respondent's attempt to tax him on this interest in 1940 had it not been physically paid to and resported by Lake in that year? That is a fair test, and the only answer to the inquiry is that Lake could not have avoided reporting the interest in 1940, even though he had not actually or physically collected it in that year.

Respondent's assertion that "There can be no constructive receipt without an unconditional credit on the books of the debtor in favor of the creditor, and the interest in the instant case was not credited to Lake on the taxpayer's books * **" (Brief 8) is unfounded. It is unfounded, first, because "Undrawn salary may be constructively received even where not credited where the taxpayer was the controlling shareholder and could have withdrawn the salary without financial embarrassment to the corporation."[2] The Treasury Department makes no credit on its records of interest due on unregistered United States bonds. Yet, the holder of such a bond is in constructive receipt of income when the interest coupon becomes due, even though not cashed and even though not credited to him on the books or records of the Treasury Department.[3]

The above quoted assertion from respondent's brief is unfounded, second, because the interest in question was set up in an "accrued interest payable" account on the books of the petitioner from month to month as it accrued. This account included only interest upon the indebtedness due Lake. The amount of the

[2]Merten's **Law of Federal Income Taxation**, Vol. 2, paragraph 10.13, page 21. The same principle is, of course, as applicable to interest as to salary. See also **A. R. R. 4385**, II-2 Cum. Bull. 81.

[3]Sec. 19.42-3, Regs. 103: "If interest coupons have matured and are payable, but have not been cashed, such interest, though not collected when due and payable, shall be included in gross income for the year during which the coupons mature, unless it can be shown that there are no funds available for payment of the interest during such year."

accrual was treated and considered by petitioner and Lake as an unconditional obligation due by petitioner to Lake. It cannot be said, therefore, that an unconditional credit in favor of the creditor on petitioner's books was not made.

The case of *Jenkins v. Bitgood*, 101 F. (2d) 17 (C. C. A. 2) certiorari denied 307 U. S. 636, cited by respondent for the proposition that constructive receipt is not correlative with payment (Brief 8) involved the right of a taxpayer to a loss deduction where notes of the taxpayer, who was on the cash basis of accounting, were not paid within the taxable year. This is the same type of situation considered by this Court in *Helvering v. Price*, supra, and is no authority on the problem in the case at bar. (See footnote 5, Pet.).

III.

Respondent's statement in his brief that the "Tax Court has not always been consistent in its various holdings under Section 24(c) * * * (Brief 8) strongly supports petitioner's Reason II (Pet. 11-16, incl.) for granting the writ; viz, the Court below decided an important question of federal law which has not been, but should be, settled by this Court.

The Tax Court's inability consistently to decide the cases arising under Section 24(c) is due to lack of authoritative rules of guidance. This unhealthy situation has been accentuated by the conflict existing in the decisions of the Sixth Circuit Court in the *Musselman* case, supra, and of the Fifth Circuit Court of Appeals in the instant case. The uncertainty and

chaos resulting from the conflicting decisions has permeated the administration of this statute, leaving Government and taxpayer alike on infirm and uncharted ground. The situation requires action by this Court, not only to resolve the existing conflicts but to prevent those that will inevitably arise, as indicated by the course of the decisions of the trial and appellate courts. (Pet. 12 et seq.).

CONCLUSION

For the reasons herein given, as well as those contained in the Petition for Writ of Certiorari, it is respectfully prayed that said petition be granted.

HARRY C. WEEKS,
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Fort Worth, Texas,
Attorney for Petitioner.

WEEKS, BIRD & CANNON,
Fort Worth, Texas.
Of Counsel.

No. 216

IN THE

Supreme Court of the United States

(October Term, 1945)

P. G. LAKE, INC.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR REHEARING

HARRY C. WEEKS
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Attorney for Petitioner.

Of Counsel:
Weeks, Bird & Cannon
Fort Worth, Texas

COMMERCIAL RECORDER, FORT WORTH

No. 210

IN THE

Supreme Court of the United States

(October Term, 1945)

P. G. LAKE, INC.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR REHEARING

P. G. Lake, Inc., prays that this Honorable Court rehear and reconsider its order of October 8, 1945, denying the petition for writ of certiorari filed in this cause to review the judgment of the United States Circuit Court of Appeals for the Fifth Circuit entered in the above styled cause on April 17, 1945, and reported in 148 F. 2d 898, affirming decision of the Tax Court of the United States, reported in 4 T. C. 1. As grounds for this petition for rehearing, your petitioner states:

1. Fairness and good conscience require that your petitioner's prayer for rehearing be granted. It is morally wrong for the Government to mulct its citizens in such manner as was done here. The administrative agency of the Government charged with the duty of administering the Revenue Laws has perverted a law aimed at tax evaders into an instrument of harassment of innocent taxpayers. No tax evasion was attempted, thought of, practiced, or accomplished by your petitioner or its stockholder, P. G. Lake. Each has paid his full share of taxes due the Government from this transaction. Nonetheless, your petitioner has been penalized by application of a law which was never intended by Congress to apply to it, or to taxpayers similarly situated. The Sixth Circuit Court of Appeals recognized this injustice and remedied it by its decision in *Musselman Hub-Brake Company v. Commissioner of Internal Revenue*, 139 F. 2d 65, which directly conflicts with the holding below. Your petitioner is entitled to equal consideration and relief. Unless this Honorable Court grants this petition, your petitioner will have irretrievably lost a substantial sum of money through the inequitable and harsh application of a law never intended to apply to it. Thus, the Treasury is engaging in the very acts which Congress, at the instance of the Treasury, condemned taxpayers for practicing when the Section was enacted; it is using a strained, artificial construction to collect taxes which Congress never intended to be collected; just as some taxpayers had strained the ordinary deduction for interest (Section

23(b), Internal Revenue Code) to secure artificial deductions.

Such official conduct does not prevent, but encourages, similar acts by taxpayers to the serious detriment of an orderly, fair administration of Revenue laws.

2. That even if the word "paid" as used in *Section 24(c)(1)* of the *Internal Revenue Code* means to liquidate a liability in cash, as held by the Court below, your petitioner complied with said statute to the extent of $32,226.89, and is entitled to a deduction in said amount for interest paid.

The aforesaid amount of $32,226.89 is the sum of money withdrawn from petitioner by P. G. Lake, its creditor and sole stockholder, for his own uses and purposes, between January 1, 1940 and March 15, 1940, the statutory two and one-half month period. (R. 16.) Thus, as of March 15, 1940, petitioner owed P. G. Lake $56,000.00 (R. 41), and Lake owed petitioner $32,226.89. It is obvious, therefore, that by law there occurred an extinguishment of, or offset to, petitioner's liability to Lake, to the extent of the sum of $32,226.89. Cf. *Holliman v. Rogers*, 6 Tex. 91. There is no doubt but that Lake could not have enforced the collection of the full amount of $56,000.00 of interest here in question on March 15, 1940, or at any time thereafter. He would have been required to offset the amount shown by his open account ($32,226.89) against this indebtedness. Matters of taxation are to be determined by practical considerations.

From a practical point of view, your petitioner actually paid, discharged, and was no longer liable for, as of March 15, 1940, $32,226.89 of the interest indebtedness in question, and the obligation of petitioner's stockholder, Lake, to report that amount as income received during that period cannot be questioned. This satisfies the statute, under any possible construction. Petitioner is, therefore, entitled to a deduction from its gross income of interest paid to the extent of $32,226.89.

WHEREFORE, petitioner respectfully prays that the petition be granted.

HARRY C. WEEKS
909-913 Sinclair Building
Fort Worth, Texas
Attorney for Petitioner.

Of Counsel:
Weeks, Bird & Cannon
Fort Worth, Texas

I, Harry C. Weeks, Attorney for Petitioner, hereby certify that the foregoing petition for rehearing is presented in good faith and not for delay.

_____

Harry C. Weeks.

No. 212

IN THE

SUPREME COURT OF THE UNITED STATES

(OCTOBER TERM, 1945)

P. G. LAKE, INC.,

PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE,

RESPONDENT

On Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit

BRIEF OF AMICUS CURIAE IN SUPPORT OF PETITION FOR REHEARING

W. A. SUTHERLAND
Amicus Curiae

ST. LOUIS LAW PRINTING CO., 415 North Eighth Street. CEntral 4477.

No. 210

IN THE

SUPREME COURT OF THE UNITED STATES

(OCTOBER TERM, 1945)

P. G. LAKE, INC.,

PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE,

RESPONDENT

On Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit

MOTION FOR LEAVE TO FILE BRIEF AS AMICUS CURIAE.

The undersigned respectfully moves this Honorable Court for leave to file the annexed brief as amicus curiae in the above entitled cause.

Respectfully submitted,

W. A. SUTHERLAND,

Amicus Curiae.

No. 210

IN THE

SUPREME COURT OF THE UNITED STATES

(OCTOBER TERM, 1945)

P. G. LAKE, INC.,

PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE,

RESPONDENT

On Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit

BRIEF OF AMICUS CURIAE IN SUPPORT OF PETITION FOR REHEARING.

W. A. Sutherland of Atlanta, Georgia, pursuant to leave of Court, files this brief as amicus curiae in support of the petition for rehearing filed in the above entitled cause. It is respectfully submitted that the petition for rehearing should be granted for the reasons hereinafter set out in this brief.

This brief is filed primarily because of counsel's interest in what seems to him to be a breakdown of the administrative process which is so clearly illustrated by the Commissioner's position in the present case.

This Court has been much disturbed by the number of tax cases which it has been called upon to consider in recent years. The voluminous amount of such litigation in this Court is symptomatic of the large volume of tax controversy—much of it avoidable—which now burdens the courts, the treasury and the taxpayer. The present case affords an opportunity for this Court to see clearly into one of the chief causes of the difficulty, and to do much to alleviate the situation by an emphatic statement definitely and openly placing a large part of the blame where it belongs.

The willingness of the Commissioner of Internal Revenue to make such an unfair, extreme and unfounded contention as underlies the present controversy illustrates, with a clarity and simplicity unusual in the tax field, one of the primary causes of the increasing volume of tax litigation. That is the apparent unwillingness of the persons charged with the administration of the tax laws fairly to decide the questions constantly presented to them and to keep out of litigation questions which sound and fair administration would dictate should not be litigated. Because this evil is so clearly posed in the present case, this Court would, if it granted certiorari, have an unusual opportunity clearly and forcefully to point out the fault in the administrative process which is defeating all efforts to achieve simplicity and certainty in our tax laws. We believe that such action by this Court would have a most salutary effect and that it might greatly restrict the volume of tax litigation and alleviate the burden of taxpayers, of the Courts and of the Treasury Department as well.

Section 24 (c) of the Internal Revenue Code, as its legislative history shows and *as everyone with experience in the tax field knows*, was enacted for one purpose, and only for one purpose, namely, to prevent closely held corporations, reporting on the accrual basis, from taking deduction for an accrual in favor of a controlling stockholder reporting on the cash basis, where the person in favor of whom the accrual is made is not required to report the amount as income. The Section had no other purpose, as those charged with the administration of the law could not fail to recognize. The language of the Section is entirely appropriate to accomplish its purpose without involving hardship to anyone. The requirement of the section that a deduction be allowed as a deduction to the corporation on an accrual basis only if the accrued amount is "paid" within 75 days after the close of the taxable year is directed solely to preventing said amount from being allowed as a deduction to the corporation unless it promptly becomes a part of the taxable income of the stockholder. If the taxpayer is on the accrual basis so that he must report the accrual as income whether or not it is paid, the Section has no application.

It is obvious, therefore, that if an amount has been "received" by the payee in any manner, actually or constructively, which makes it a part of said payee's income, the entire purpose of the statute has been served. While in some connections "paid" may have other meanings, to hold that, under the section in question, an amount has not been "paid" when it has admittedly been "received" by the payee so that it must be reported in his income, is such an obvious distortion of the plain intent of the statute as to call not only for a reversal but also for a clear statement by this Court of the failure of the administrative process which burdens the public and the courts with litigation of such matters.

Even in the absence of any court decision, it is difficult to understand why the Commissioner should ever have attempted to read into a *loophole stopping statute like Section 24 (c)* a meaning which would extend its operation entirely beyond the evil at which it obviously was aimed and thereby work hardships upon persons who are in no way offending against the purpose of the statute. But after the pronouncement of the Circuit Court of Appeals for the Sixth Circuit in the case of *Musselman Hub-Brake Co. v. Commissioner*, 139 F. (2d) 65* clearly reviewing the legislative history and clearly setting forth the obviously correct interpretation of the section, the action of the Commissioner in continuing the effort to extend the section beyond its plain intent is beyond understanding.

It is earnestly to be hoped that this Court will grant writ of certiorari prayed for in the petition, not only in order to set at rest the very substantial amount of needless litigation with reference to this section, which is now pending and will continue until this Court has spoken, but also in order that the Court may take the opportunity which this case affords to inquire into the failure of the administrative processes, out of which arises the present attempt to misuse a fair and reasonably clear loophole

*The decision in the case at bar is clearly in conflict with the decision of the Circuit Court of Appeals for the Sixth Circuit in the case of *Musselman Hub-Brake Co.*, supra. The differences in the factual situations presented are entirely unimportant. The *Musselman* case recognizes the clear purpose of the statute and properly interprets the language so as to confine it to the purpose which it was intended to serve—the prevention of an unfair advantage against the Government when a controlled payor is on a different basis of accounting from the controlling payee. The case at bar completely ignores the purpose of the statute and twists it into an instrument of obvious injustice to the taxpayer. The *Musselman* case holds that when an amount is *constructively received* by the payee, so that it becomes a part of his taxable income, it is *"paid"* by the corporation within the meaning of Section 24 (c); the case at bar says that constructive receipt by the payee, who must then return the amount as his income, is insufficient.

stopping statute so as to work obvious hardships upon persons clearly without the scope of the statute's purpose and who are in no way required to be considered within its language.

The tax system of the Federal Government, already complex and overburdened with litigation, will become more and more cumbersome and the courts will be more and more filled with tax controversies unless there is developed in the officers charged with the administration of the law an attitude of fairness, which the litigation over this little remedial section would indicate is lacking. The present case is unusual in that its very simplicity makes the administrative failure so obvious. Congress cannot pass enough curative legislation or express its intention with sufficient clarity ever to clarify the tax situation if such extreme administrative constructions are permitted to stand; or if the administrative attitude out of which the construction arises is to receive the approval of the courts.

Respectfully submitted,

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